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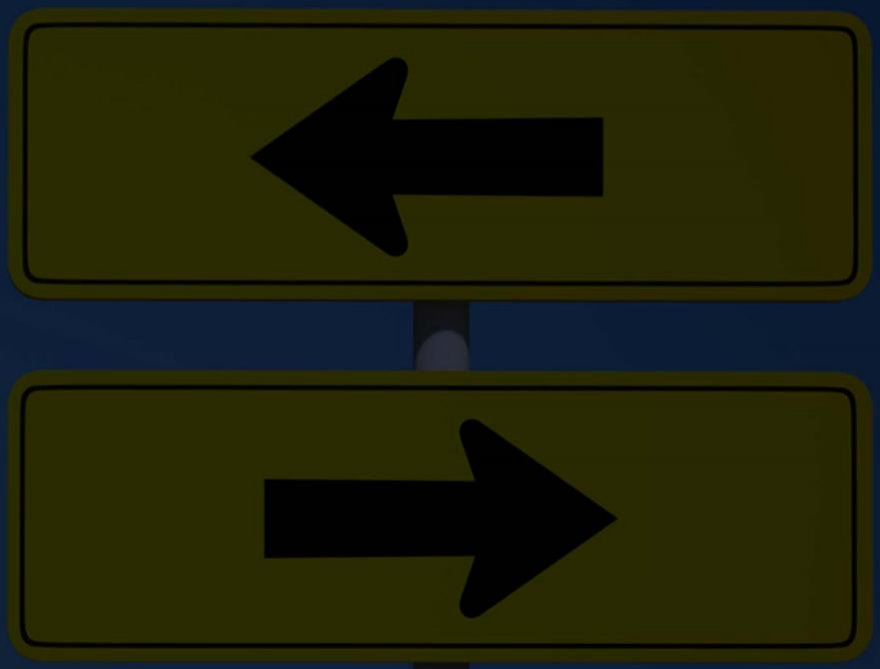

Contractor v Employee
The ATO's Response

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Please direct any questions regarding the Contractor vs Employee: The ATO's Response White Paper to:
Knowledge Shop Pty Ltd, Level 7, 115 Pitt St, Sydney 2000
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Contractor v Employee: The ATO’s Response

Hi there,

The contractor/ employee distinction has been problematic for the profession for many years. It is also an area where clients are often unaware of the broader implications.

The Knowledge Shop membership help desk answers thousands of questions from practitioners and advisers every month. The practical tax and super implications of employment relationships and business structures often arises. To help clarify the latest changes and guidance on the contractor v employee distinction, we’ve brought together an update that consolidates the issue for practitioners:

- The High Court decisions and their implications
- The ATO's response and the expectations of the regulators
- The practical implications

The Knowledge Shop membership makes life in practice just that bit simpler and more efficient for you and your team. We do this through the help desk, workpaper knowledge base, quarterly CPD, and more - wherever you are and however you are working.

This guide to the contractor/ employee distinction is just a small sample of the breadth of knowledge we can deliver to your team. Want to see for yourself? Book in a time for a tour or give me a call.

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Contractor or Employee The ATO's Response

When a business engages a worker it will normally be necessary to determine whether the worker should be classified as an employee of the business or whether they should be classified as a genuine independent contractor. This classification can have a significant impact on the obligations that need to be satisfied by the business that has engaged the worker and the tax implications for the worker.

While sometimes it will be relatively easy to determine whether a worker should be classified as an employee or contractor, this is not always the case and this can give rise to some significant risk issues, especially for the business that has engaged the worker. For example, if the business treats the worker as a contractor but they are really an employee then this could trigger penalties and adverse implications under the PAYG withholding rules, the superannuation guarantee (SG) rules, state-based systems and under employment law.

The other thing that business operators need to remember is that the definition of employee is not always the same across different areas of the tax system. For example, the SG system contains an extended definition of employee which means that a business might be subject to SG obligations even though the worker is a genuine independent contractor.

Two recent High Court decisions fundamentally change the way we need to distinguish between employees and contractors when assisting clients in this area. While the High Court decisions make it clear that we need to focus on the terms of the contract between the parties, this does not mean that simply labelling a worker as an independent contractor in a written contract is enough (as you will see in CFMMEU v Personnel Contracting). Let's look at the issue:

The recent High Court decisions

As the distinction between an employee and contractor is relevant to a number of different areas, there has been a reasonable volume of case law on this issue. While we won't be undertaking a detailed analysis of all of the recent cases that have been decided on this issue in this white paper, it is worth noting that the High Court handed down two key decisions on the employee v contractor issue in February 2022 that have impacted the way that advisers need to approach this area.

'Contractor' an employee: CFMMEU v Personnel Contracting

Facts:

- Individual on a working holiday visa obtained a "white card" enabling him to work in construction
- Employed by a labour hire company as a "self-employed contractor"
- Individual purchased hard hat, steel-capped boots and high vis clothing
- Commenced work on a building site under the supervision and direction of the building company
- Individual worked for the building company between July and November 2016 then left Perth. In March 2017, he returned and commenced work for the same building company on a different site in a substantially identical role. On 20 June 2017, he was advised that his services were no longer required.
- No contractual arrangement between the individual and the building company – only

between the labour hire company and building company, and individual and labour hire company.
- Workers from labour hire company referred to building company on a “daily hire basis” based on an hourly rate and invoiced weekly
- Proceedings commenced to determine whether individual was an employee of the labour hire company

In *Construction, Forestry, Maritime, Mining and Energy Union v Personnel Contracting Pty Ltd* [2022] HCA 1 the High Court held that an individual was an employee of a labour hire company.

The fact that the parties chose to use the label "contractor" to describe the individual did not change the character of that relationship.

The worker in this case was a 22-year-old British backpacker (Mr McCourt) with limited work experience who had travelled to Australia on a working holiday visa. He was offered a role with a labour hire company (Construct) and signed an Administrative Services Agreement (ASA) with the company. The ASA described the individual as a "self-employed contractor". The company assigned the individual to work on two construction sites run by a client of the company (Hanssen). The individual performed basic labouring tasks under the supervision and direction of supervisors employed by the client.

The individual and the CFMMEU commenced proceedings against the labour hire company in the Federal Court, arguing that he was an employee under the *Fair Work Act 2009*. The primary judge held that the individual was an independent contractor and an appeal to the Full Federal Court was dismissed. Both courts applied a multifactorial approach, referring to the terms of the ASA and the work practices imposed by the company and its client.

However, the High Court held that the individual was an employee of the company. The majority held that where parties have comprehensively committed the terms of their relationship to a written contract and this is not challenged on the basis that it is a sham etc., the characterisation of the relationship is to be determined with reference to the rights and obligations of the parties under that contract. Absent a suggestion that the contract has been varied, or that there has been conduct giving rise to an estoppel or waiver, a wide-ranging review of the parties' subsequent conduct is not necessary or appropriate.

Under the ASA, the company had the right to determine for whom the individual would work, and the individual promised the company that he would co-operate in all respects in the supply of his labour to the client. In return, the individual was entitled to be paid by the company for the work he performed.

This right of control, and the ability to supply a compliant workforce, was the key asset of the company’s business as a labour-hire agency. These rights and obligations constituted a relationship between the company and the individual of employer and employee. The fact that the parties chose to use the label “contractor” to describe the individual did not change the character of that relationship.

> *Under the ASA, Mr McCourt promised Construct to work as directed by Construct and by Construct's customer, Hanssen. Mr McCourt was entitled to be paid by Construct in return for the work he performed pursuant to that promise.*

That promise to work for Construct's customer, and his entitlement to be paid for that work, were at the core of Construct's business of providing labour to its customers. The right to control the provision of Mr McCourt's labour was an essential asset of that business. Mr McCourt's performance of work for, and at the direction of, Hanssen was a direct result of the deployment by Construct of this asset in the course of its ongoing relationship with its customer.

In these circumstances, it is impossible to conclude other than that Mr McCourt's work was dependent upon, and subservient to, Construct's business. That being so, Mr McCourt's relationship with Construct is rightly characterised as a contract of service rather than a contract for services. Mr McCourt was Construct's employee.

No relationship of employment: ZG Operations v Jamsek

Facts:

- Between 1977 and 2017, two individuals engaged as truck drivers for a company
- In late 1985/ early 1986 company insists that it will no longer employ individuals unless they purchase their trucks and enter into an agreement with the company
- The individuals agreed and each established partnerships with their wives
- The partnerships purchased trucks from the company and executed agreements for the provision of delivery services
- The partnerships made deliveries as requested by the company and invoiced the company for those deliveries
- Revenue earned was used to meet the partnerships' costs of operating the trucks, net revenue declared as partnership income and split between husband and wife for income tax purposes
- Company had undergone several changes of ownership over the period
- The agreement between the company and the partnerships was terminated in 2017
- Proceedings commenced seeking entitlements for the drivers as employees of the company

In *ZG Operations & Anor v Jamsek & Ors* [2022] HCA 2, the High Court held that two truck drivers were not employees.

For around 40 years, two individuals were engaged as truck drivers by a business run by a company. The individuals were initially engaged as employees of the company and drove the company's trucks. However, in the mid-1980's the company offered the individuals the opportunity to become contractors and purchase their own trucks. The individuals agreed to this and set up partnerships with their respective wives.

Each partnership executed a written contract with the company for the provision of delivery services, purchased trucks from the company, paid the maintenance and operational costs of those trucks, invoiced the company for its delivery services, and was paid by the company for those services. The income from the work was declared as partnership income for tax purposes and split between each individual and their wife.

The individuals commenced proceedings in the Federal Court arguing that they were employees of the company and were owed certain entitlements such as SG and paid leave. The primary judge initially held that they were independent contractors, but the Full Federal Court overturned the decision and held that they were employees.

The High Court held that the individuals were not employees of the company. Consistent with the decision in the *Personnel Contracting* case (see above), a majority of the Court held that where parties have comprehensively committed the terms of their relationship to a written contract (and this is not challenged on the basis that it is a sham or is otherwise ineffective under general law or statute), the characterisation of the relationship must be determined with reference to the rights and obligations of the parties under that contract.

...where parties have comprehensively committed the terms of their relationship to a written contract … the characterisation of the relationship must be determined with reference to the rights and obligations of the parties under that contract.

After 1985 or 1986, the contracting parties were the partnerships and the company. The contracts between the partnerships and the company involved the provision by the partnerships of both the use of the trucks owned by the partnerships and the services of a driver to drive those trucks. This relationship was not a relationship of employment.

The ATO's response

ATO decision impact statement

While the ATO was not a party to the cases referred to above, the ATO has issued a decision impact statement in relation to the *Personnel Contracting* case and has recently issued updated guidance in this area.

The ATO observed that the High Court has not disturbed the well-established practice of examining the totality of the relationship. However, the court has clarified that it is necessary to focus on the terms of the written contract between the parties to establish the character of the relationship if that contract is an accurate and accepted record of the agreement struck between the parties.

Labels which are inconsistent with the rights and obligations under the contract should be ignored when classifying the worker.

The High Court concluded that a multifactorial approach which considers all of the relations between the parties over the entire history of their dealings was not necessary or appropriate. However, Kiefel CJ, Keane, Edelman, Gordon and Steward JJ considered that a Court may look beyond a written contract and consider the conduct of the parties in circumstances where:

- The contract is an oral contract, or is partly written and partly oral to determine when the contract was formed and the contractual terms that were agreed;
- The terms of the written contract have been varied;
- The terms of the written contract are being challenged as invalid (for example, being a sham); or
- A party to the contract asserts rectification, estoppel or any other legal, equitable or statutory rights or remedies.

The long-established employment indicia are still relevant when characterising the contractual relationship between the parties. However, they are to be considered through the focusing question or prism of whether the worker is working in the business of the employer. This reflects the Commissioner's understanding and application of the business integration test. The High Court has elevated that test as one of the primary and focusing aspects of the examination of the contractual terms. In addition, the High Court has continued the emphasis on the examination of control as a complementary focus to the business integration test.

The High Court's commentary that the use of labels in a contract should not be determinative of the nature of a relationship is consistent with existing views articulated by the Commissioner in several public advice and guidance products.

TR 2022/D3

In December 2022, the ATO issued TR 2022/D3, which replaces TR 2005/16. The ruling explains how to determine whether a worker is an employee under the ordinary meaning of the term and in the context of the PAYG withholding rules. The ruling specifically takes into account the High Court decision in the Personnel Contracting case.

The ATO indicates that whether a worker is an employee of an entity under the ordinary meaning of the term is a question of fact to be determined by reference to an objective assessment of the totality of the relationship between the parties. In undertaking this assessment, you must only have regard to the

legal rights and obligations which constitute that relationship. This involves construing and characterising the contract at the time it is entered into.

If the worker and the engaging entity have comprehensively committed the terms of their relationship to a written contract then it is the legal rights and obligations in the contract alone that are relevant in determining whether the worker is an employee. The main exceptions to this are where the contract has not been challenged as a sham or the terms of the contract have been varied, waived, discharged or the subject of an estoppel or any equitable, legal or statutory right or remedy. Evidence of how the contract was performed, including subsequent conduct and work practices, cannot be considered for the purpose of determining the nature of the legal relationship between the parties.

The label used by the parties to describe the relationship is not determinative of the classification. Labels which are inconsistent with the rights and obligations under the contract should be ignored when classifying the worker. In determining whether a worker should be classified as an employee there are a range of tests that need to be considered. The ATO indicates that the key distinction between an employee and an independent contractor is that:

- An employee serves in the business of an employer, performing their work as a representative of that business.
- An independent contractor provides services to a principal's business, but the contractor does so in furthering their own business enterprise; they carry out the work as principal of their own business, not a representative of another.

In addition to looking at whether the worker is serving in the engaging entity's business, it is important to consider the extent to which the business can control how, where and when the workers perform their work. It is necessary to focus on the contractual right of the business to exercise such control rather than whether it is actually exercised.

Aside from these two key factors there are a number of other indicia that could be relevant in classifying the worker, including:

- The ability to delegate work;
- Whether the contract is on a results basis;
- Which party provides the tools and equipment;
- Risk; and
- Generation of goodwill.

Many clients and practitioners assume that no employment relationship will arise if the worker performs their work through a company or trust. However, this is a dangerous assumption to make and the outcome will depend on the arrangement. In TR 2022/D3, the ATO states that where a worker engages to perform work for a business as a partner of a partnership or through a company or trust then this may indicate an intention by all parties not to create an employment relationship. However, a different conclusion may be reached if a worker uses an interposed entity but is also directly a party to the contract with the engaging entity.

PCG 2022/D5

In addition to the updated draft tax ruling, the ATO has issued a draft PCG that explains how the ATO will allocate compliance resources in connection with the classification of a worker as an employee or independent contractor.

In PCG 2022/D5 the ATO outlines some of the consequences of a worker's classification. If the worker is treated as an employee of the engaging entity, then:

Consequences for the engaging entity
• Report via Single Touch Payroll • Withhold amounts under the PAYG withholding regime • Make superannuation contributions or be liable for the superannuation guarantee charge • Meet fringe benefits tax obligations for benefits provided • Not entitled to claim input tax credits for wages paid
Consequences for the worker
• Not entitled to an ABN in relation to that employment • Not entitled to register for goods and services tax (GST) and no GST reporting obligations in relation to that employment

On the other hand, if the worker is treated as a genuine independent contractor, then:

Consequences for the engaging entity
• Report via Taxable Payments Annual Reporting as legislated or on a voluntary basis if they satisfy the turnover-threshold test • If the worker satisfies the extended definition of employee, make superannuation contributions or be liable for the superannuation guarantee charge • If the engaging entity and worker are both registered for GST, claim eligible input tax credits • If the worker does not quote an ABN when required, or the parties enter into a voluntary agreement, withhold amounts under the PAYG withholding regime
Consequences for the worker
• Make provision for income tax through PAYG instalments, if required • Entitled to apply for an ABN • Register for and paying GST, if required • Consider the personal services income implications

The draft PCG then outlines the risk framework that will be used by the ATO for worker classification issues, based on the actions taken by the parties when entering into the arrangement. It is important to recognise that the draft PCG **does not** extend to the following matters:

- The income tax affairs of the worker, including whether they are able to claim deductions or concessions associated with carrying on a business or whether the PSI rules apply to their arrangement;
- Employment law issues under the Fair Work Act 2009;
- State revenue issues such as payroll tax;
- Comcare and other worker insurance-related matters; and
- Obligations under a contractor or an applicable award or enterprise agreement (including where the obligations relate to the payment of superannuation).

The risk framework is made up of four zones, which are briefly summarised below:

Risk zone	ATO approach
Very low	No further compliance resources will be applied.
Low	Compliance resources will only be applied to test whether the worker meets the extended definition of employee under the SGAA if the review is the result of an unpaid superannuation query received from a worker.
Medium	Compliance resources will be applied to test the correct worker classification for the arrangement but will be given lower priority than arrangements that are rated high risk.
High	Compliance resources will be applied to test the correct worker classification for the arrangement and will be given the highest priority resourcing. Businesses may be subject to higher penalties if it is found they failed to correctly classify their workers.

An explanation of the different risk zones is set out below extracted from the draft PCG.

Very low risk arrangements

An arrangement will fall into the very low-risk zone if all of the following are met:

- There is evidence to show that both parties agreed for the worker to be classified in a particular way;
- There is evidence the parties both understood the tax and superannuation consequences of that classification and intended for that to be the classification. Evidence could include documentation such as an accepted record of discussions between the worker and the engaging entity and any correspondence between parties on the intention and consequences of the classification;
- The performance of the arrangement has not deviated significantly from the contractual rights and obligations agreed to by the parties;
- The party relying on the PCG obtained specific advice confirming that their classification was correct under both the common law definition of employee and the extended definition. The advice must be professional advice from the engaging entity's in-house counsel or an appropriately qualified third party, such as a solicitor or tax professional, an administrative body or client-specific written advice from the ATO; and
- The party relying on the PCG is meeting the correct tax, superannuation and reporting obligations that arise for that classification, including voluntarily reporting under TPAR where a business satisfies the turnover threshold test.

For an engaging entity relying on the PCG, the arrangement will only fall into the very low-risk zone if the entity can demonstrate they have also satisfied the criteria above in relation to the extended definition of 'employee' for superannuation purposes.

An arrangement can also fall into the very low-risk category if the engaging entity voluntarily decides to meet employer obligations regardless of their view of the classification. This includes voluntarily engaging in PAYG withholding for the worker, reporting via Single Touch Payroll or the taxable payments reporting system, and making superannuation contributions on behalf of the worker.

Example 1 - very low risk - business and worker acting consistently with an agreed and understood relationship

A manufacturing business entered into a contract with a software engineer, Brett, to design, develop, test and install a new software program. The business engaged Brett as an independent contractor and the agreement between the business and Brett indicated this classification.

In seeking to rely on the draft PCG, the business identified the following facts that show it satisfied the criteria listed in paragraph 21 of the PCG in determining the risk zone of the arrangement:

- the business had a record of discussions with Brett in which it highlighted that he was being engaged differently from the business' employees and why he was a contractor and not entitled to superannuation
- the business had procedures in place to ensure the terms of contracts and the tax and superannuation implications for Brett were explained, understood and acknowledged
- neither Brett's nor the business' subsequent actions suggested any significant deviation from the contracted arrangement; Brett acted consistently with that arrangement by applying for an ABN

and through the way in which he reported his income, claimed business deductions and dealt with GST
- the business had obtained professional advice from an employment lawyer regarding their arrangement with Brett and their resulting tax and superannuation obligations, which indicated that the classification was correct and Brett did not satisfy the extended definition of employee for superannuation purposes, and
- the business complied with all of the taxation and reporting obligations arising from its engagement of Brett as a contractor, including voluntarily reporting the payments made to Brett through TPAR.

The arrangement is rated in the very low-risk zone. No further compliance resources will be applied to scrutinise whether Brett should instead have been classified as an employee of the business.

Example 2 - very low risk - business engages both contractors and employees - relationships are agreed and understood

Aussie Building Cleaners Pty Ltd (ABC) operates a cleaning business. The business does not have established premises; rather, cleaners attend a client's premises to undertake their duties. Some of the cleaners were employed by ABC under conventional contracts of employment, while other cleaners were engaged as independent contractors. While similar duties were undertaken by both kinds of cleaners, the terms and conditions differed significantly between the 2 kinds of arrangements.

Maria was one of ABC's window cleaners who was engaged as an independent contractor. After working for ABC for several years, Maria ceased her engagement with them. Subsequently, she lodged an unpaid superannuation query with the ATO claiming she should actually have been classified as an employee of ABC.

When Maria was engaged, ABC gave Maria the choice of entering into either kind of arrangement, noting that she would not be required to do the work herself if she was engaged as an independent contractor. Maria chose the independent contractor arrangement. The actions of Maria and ABC demonstrate they understood the differences between hiring someone as an independent contractor and hiring someone as an employee.

ABC also identifies the following facts that show it satisfied the criteria in paragraph 21 of the draft PCG in determining the risk zone of the arrangement:

- a written contract of engagement was provided to Maria which outlined the role, responsibilities and remuneration
- records of discussions between ABC and Maria demonstrate that both parties understood and acknowledged the tax and superannuation implications of engagement as an independent contractor rather than an employee
- Maria's subsequent actions did not suggest any significant deviation from the contracted arrangement; she acted consistently with the arrangement by applying for an ABN, invoicing ABC for her work using this ABN, reporting her income as business income and claiming business deductions
- ABC had obtained administratively binding advice from the ATO indicating that the appropriate worker classification had been reached for both kinds of arrangements and that workers in Maria's circumstances would not be employees under the extended definition for superannuation purposes; they shared a copy of both pieces of advice with Maria in explaining to her their position that she was not entitled to superannuation, and

- ABC complied with all of the taxation and reporting obligations arising from its engagement of Maria as a contractor, including reporting payments made to Maria through TPAR.

The arrangement is rated in the very low-risk zone. While the ATO investigates Maria's unpaid superannuation query to determine the risk zone, no further compliance resources will be applied to scrutinise whether Maria should instead have been classified as an employee of the business. The ATO will notify Maria of this outcome in response to her unpaid superannuation query.

Low risk arrangements

An arrangement will fall into the low-risk zone if all of the following are met:

- There is evidence to show that both parties agreed for the worker to be classified in a particular way;
- The performance of the arrangement has not deviated significantly from the contractual rights and obligations agreed to by the parties;
- The party relying on the draft PCG obtained specific advice confirming that their classification was correct under both the common law definition of employee and the extended definition; and
- The party relying on the draft PCG is meeting the correct tax, superannuation and reporting obligations that arise for that classification, including voluntarily reporting under TPAR where a business satisfies the turnover threshold.

Example 3 - low risk - no evidence that the employee understood the tax or superannuation consequences of the classification

CCC Pty Ltd engages workers to deliver pamphlets of their products to encourage local sales. Frank was offered a job and signed a written contract stating he was an independent contractor. CCC Pty Ltd did not pay Frank superannuation and complied with all relevant tax and reporting obligations regarding Frank as an independent contractor.

CCC Pty Ltd had previously obtained professional advice regarding the classification of workers in Frank's role as being independent contractors and discussed Frank's classification based on this advice with him.

However, CCC Pty Ltd did not discuss the impact of the classification as an independent contractor with Frank or what it meant for Frank's tax and superannuation obligations.

Although he follows the duties outlined in the contract, given the nature of the role, Frank considered he might be entitled to superannuation and lodged an unpaid superannuation query with the ATO.

As CCC Pty Ltd has not taken action to ensure an understanding with Frank regarding the tax and superannuation impacts of the independent contractor classification, the arrangement cannot be rated in the very low-risk zone. The arrangement is instead rated in the low-risk zone and compliance resources will be applied to test if Frank satisfied the extended definition.

Medium-risk arrangements

An arrangement will fall into the medium-risk zone if all of the following are met:

- There is evidence to show that both parties agreed for the worker to be classified in a particular way; and
- The party relying on the draft PCG obtained specific advice confirming that their classification was correct under both the

common law definition of employee and the extended definition.

Example 4 - medium risk - business and worker agreed to relationship

Truck Takers Pty Ltd (Truck Takers) operates a courier service for parcels. It engages some workers as employees while others that are engaged for 'overflow' delivery services during busy periods are classified as independent contractors.

After these overflow arrangements had been running for some time, the ATO identified Truck Takers' arrangements with their workers for review, based on risk factors and known information.

The following facts show that Truck Takers satisfied the criteria in paragraph 28 of the draft PCG in determining the risk zone of the arrangement:

- the overflow workers signed written contracts with Truck Takers which described them as independent contractors; however, there is no evidence that Truck Takers engaged further with the workers to help them understand the reasons for the classification and the tax and superannuation implications of this classification, and
- the business had obtained independent advice from an employment lawyer regarding arrangements for workers providing their overflow delivery services, which indicated that the classification was correct under both the common law and extended definition of employee.

The arrangement is rated in the medium-risk zone, as there is a lack of evidence to demonstrate that Truck Takers took action to ensure the workers understood the reasons for, and consequences of, their classification.

Compliance resources will be applied to scrutinise whether the overflow workers should instead have been classified as employees of Truck Takers.

High-risk arrangements

An arrangement will fall into the high-risk zone if it does not fall in the very low, low or medium-risk categories.

The following factors would typically indicate that the arrangement is high risk:

- The party looking to rely on the draft PCG did not turn any attention to the manner in which the worker in the arrangement was classified;
- The parties did not agree on a classification;
- The performance of the arrangement has deviated significantly from the contractual rights and obligations agreed to by the parties;
- One party coerced the other to accept the arrangement as being a particular classification; or
- One party made false or misleading representations to the other or deceived them into believing the arrangement had a particular classification.

Example 6 - high risk - no evidence of an agreed relationship

A restaurant hires Sam; however, no formal agreement is entered into. Sam is unsure if he is an employee or contractor. The restaurant simply asserts to Sam that he is working as an independent contractor and will require an ABN. Sam is told to accept the arrangement if he wants to be hired.

Sam becomes concerned his remuneration does not include superannuation. After reading guidance on the ATO website, he reflects on the

nature of his work and suspects he is actually an employee of the restaurant.

Sam lodges an unpaid superannuation query with the ATO.

Given the lack of a written contract and lack of evidence of the characteristics of the arrangement that were agreed to, the restaurant is unable to demonstrate that the contractual rights and obligations of the parties resulted in an independent contractor relationship.

Furthermore, the restaurant could not demonstrate they obtained professional advice from an appropriately-qualified third party about the classification or that they worked with Sam to ensure he understood the classification and consequences.

The working arrangement is rated in the high-risk zone and compliance resources will be given the highest priority to scrutinise whether Sam should instead have been classified as an employee of the restaurant.

Changed circumstances

The ATO indicates that if there is a material change in the operation of an arrangement between an engaging entity and a worker then this could impact on the worker's classification. The engaging entity should reassess the position under the draft PCG to determine whether the risk rating has changed. This could include:

- Ensuring that both parties understand the impact of the changes on their working arrangement and classification;
- Ensuring the contractual rights and obligations agreed by the parties reflect the changes in the working arrangement;
- Ensuring that, if the classification has changed, all parties understand the tax, superannuation and reporting consequences of the new classification; and
- Ensuring that new professional advice has been obtained to confirm the classification in light of the new circumstances.

Example 5 - high risk - changing circumstances not considered

Sasha entered into a fixed-term contract with a mining company to undertake a safety audit. Sasha was engaged as an independent contractor and the written contract between Sasha and the company reflected this relationship.

At the time, the arrangement was rated in the very low-risk zone as the actions of Sasha and the company demonstrated they intended to enter into an independent contracting relationship and that all parties fully understood the consequences of this classification. The mining company had also obtained professional advice from an employment lawyer regarding their arrangement with Sasha and their resulting tax and superannuation obligations, which indicated that the classification was correct and Sasha did not satisfy the extended definition of employee for superannuation purposes.

When the project concluded, the company decided to engage Sasha on a permanent basis. Her role and responsibilities changed; however, this was not reflected in a new or updated written contract between the parties. At no time did the company obtain professional advice regarding how the changed circumstances may impact their classification of Sasha as a worker. Nor did they discuss with Sasha whether the new arrangement might mean that she became their employee.

When Sasha ultimately left the company, she was concerned that the company may owe her superannuation. She lodged an unpaid superannuation query with the ATO.

While the arrangement may have previously been rated in the very low-risk zone, given the events that occurred when Sasha's engagement with the company changed, the arrangement is now rated in the high-risk zone as the company cannot demonstrate any agreement, professional advice or understanding about the classification of the new engagement. Compliance resources will be given the highest priority to scrutinise whether Sasha should instead have been classified as an employee from the time her role changed.

SG liabilities: How far back can the ATO go?

One of the things that business owners find most alarming is that there is no real time limit on the recovery of outstanding SG obligations. In theory the ATO can go back as far as it wants to recover unpaid superannuation contributions for workers who are classified as employees for SG purposes. Remember, one of the key features of the SG system is to ensure that appropriate contributions are being made for employees and deemed employees so that they can be adequately supported in their retirement.

ATO Practice Statement PS LA 2006/14 previously set out procedures for ATO staff to follow when engaged in compliance activities where the review identifies one or more individuals engaged under a contract that is wholly or principally for their labour (i.e., deemed employee). The practice statement indicated that assessments relating to SG charge liabilities could be issued up to a time limit of 5 years, although a 4 year time limit would be imposed in some situations. There were some exceptions to these time limits (e.g., where the avoidance of the SG charge was due to fraud or evasion).

The ATO has withdrawn PS LA 2006/14 on the basis that it is out of date and no longer reflects current practice. However, guidance published on the ATO website indicates that it can be difficult for the ATO to pursue unpaid super enquiries where the complaint is for a period that ended more than 5 years ago. This is because employers are only required to keep employment records for 5 years.

Having said that, even if the unpaid super claim dates back more than 5 years the ATO might be able to take steps to pursue this if the employee can provide evidence to support the claim (e.g., original payment summaries and copies of super fund statements etc).

Practical implications

Can you contract out of SG obligations?

The short answer is no.

The SG rules look at whether a worker is classified as an employee under the ordinary meaning of the term or whether the worker falls within the expanded definition of employee for SG purposes. If an entity engages someone who is classified as an employee then SG obligations will automatically follow unless a specific exclusion applies.

While businesses will sometimes attempt to contract their way out of SG obligations, the ATO and courts take a much broader view of the situation and will always attempt to discover the true nature of the arrangement or relationship.

Inserting clauses into a contract which state that the principal is not responsible for making superannuation contributions on behalf of a worker will not be effective to release the principal from their obligations under the SG provisions if the worker is classified as an

employee at common law or under the expanded definition.

Interposing a company or trust

Many people think that the best way to deal with the uncertainty on this issue is to ensure that workers set up their own company or trust and enter into contracts through that interposed entity. While this may help clarify the situation in some cases, it is definitely not a fool-proof method for dealing with this issue.

First, the ATO's recent comments in TR 2022/D3 suggest that an individual could still be treated as an employee of an engaging entity if they use an interposed entity but are also a party to the contract.

Second, there are some cases where the courts have considered this issue and have looked at the substance of the arrangement. For example, the Federal Court provided some comments on this issue in the *Roy Morgan* case. Paragraph 43 of the joint judgement handed down by the Full Court is extracted below:

> *"Roy Morgan wrongly asserted that the Tribunal failed to take into account that interviewers could incorporate. The Tribunal found that some interviewers were 'engaged under the name of a company'. It recorded the observations of Meagher JA in Vabu 33 ATR at 539 that the documents in that case contemplated that a courier may use a corporate name, and a 'company does not usually have employee corporations'. So the Tribunal was alert to the fact that an interviewer could incorporate, and that this was a relevant indicium. However it regarded it as outweighed by other indicia. It concluded that the fact that Roy Morgan paid money to 'someone other than the individual interviewer for that interviewer's assignments does not change the fact that Roy Morgan engaged the individual'. In other words it regarded the ability of an interviewer to incorporate as a factor entitled to little weight because the entity selected to do the work (conduct interviews) was the individual interviewer, and the company featured only as the recipient of the fees that would otherwise have been paid to the interviewer. No error has been shown in the Tribunal's treatment of this factor."*

The issue here was that the business was still engaging the individuals to perform the work even though the payments were being directed to a company.

Practitioners and employers need to be aware of this and ensure that they do not assume that simply because a company or trust has been set up this will protect the engaging entity from having to deal with SG obligations. If the arrangement still looks like it is a contract for the service of a particular individual then the payment of fees to an interposed entity may not be sufficient to prevent SG obligations from arising.

Written contracts

We would always recommend that a written contract or agreement be put in place when an entity is engaging a worker. Although a written contract does not provide a guarantee and the ATO and courts will still take a substance over form approach, the absence of a written agreement can make it very difficult to justify or substantiate the position that has been taken in the event that this is reviewed at a later time.

PCG 2022/D5 shows the importance of ensuring that there is evidence to show that both parties have agreed for the worker to be classified in a particular way and that both parties understand the tax and superannuation consequences of that classification and intended for that to be the classification in order to fall within the very low risk zone.

Can you make the problem go away?

For a business owner who realises they may have a potential exposure to significant SG liabilities it may be tempting to close up the business entity and either walk away completely or set up under a new business structure. Unfortunately this may not be all that effective when it comes to dealing with the ATO.

Firstly, the director penalty regime was expanded from 30 June 2012 to cover unpaid SG liabilities. This regime has been extended as part of the Government's desire to deter people from engaging in fraudulent 'phoenix' behaviour or trying to escape from liabilities and payments of employee entitlements.

Under the expanded director penalty regime, directors of a company that has not met its SG obligations can become personally liable for a penalty equal to the company's unpaid SG amounts.

The Commissioner also has the ability to estimate a company's SG liabilities if the amount has not been paid by the day on which the company is required to lodge the SG statement for the relevant quarter.

If a company does not pay the SG liability and an individual is liable for a director penalty the ATO can seek to recover the unpaid amount in a variety of ways including:

- Garnisheeing bank accounts;
- Offsetting the amount against refunds owing to the director; or
- Court action.

While placing a company into administration or liquidation can sometimes assist with this, there are strict deadlines in terms of when the PAYG or SG liabilities are reported. If a company is placed into administration or liquidation and the reporting deadlines have not been satisfied then the debt owed by the directors will not be removed.

New directors are given 30 days before they become liable for outstanding SG obligations. New directors should use this period to check that the company has met all of its SG and PAYG withholding liabilities.

The rules do provide some defences for directors in specific circumstances. One of the defences available to directors in relation to SG obligations is to show that the company applied the SGAA in a way that was reasonably arguable and the company took reasonable care in applying the SGAA to the matter in question.

While director penalty notices are not relevant to sole traders or partners in a partnership, these individuals would be personally liable for any unpaid SG liabilities anyway. The rules give the Commissioner the power to estimate the unpaid SG obligations for these people and then seek recovery of the unpaid amounts.